Financial Markets

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Irving Trust

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Economic Research &
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Over the past several weeks, the bond market has undergone a severe backup in prices. The yield on the bellwether long government bond has risen from its recent cyclical low of 10.27% to as high as 11.35%. This backup has undoubtedly disturbed the Fed. The Fed has tried to firm up short-term rates to help stem the rise in M1, but had hoped the subtle move would not impair the bond market's performance. Indeed, the realization that the Fed was fighting inflation could have helped to hold bond prices steady. That it did not tells us something about market psychology and spells trouble for the Fed.

In testimony before the Senate and House banking committees, Mr. Volcker has admitted that he has no magic buttons to press to control interest rates. The Fed can control the Fed funds rate and, to a lesser extent, can influence CD rates and, to a still lesser extent, bond rates. The Fed has been caught in this dilemma for most of this year. It has been torn between the possible need to raise short rates to stem the fast growth of M1 and the perceived need to keep bond rates and consumer loan rates down to fuel economic recovery. The recovery has occurred so far because several interest-sensitive sectors of the economy have performed well: autos and housing. Auto sales depend on short-term consumer financing rates. Mortgage rates are long-term rates that tend to track with bond rates. Thus an upward shift in the yield curve (increases in rates of all maturities) threatens several key economic sectors.

In terms of rates for the longer maturities, the Fed may be hurt by its own credibility. The bond market has seen the Fed's strong reaction in the past; thus it may fear that a near-term sharp rise in rates could occur again. Bond traders certainly are wary of this possibility, even as they are also aware that there are good reasons why rates "can't" rise too sharply this year. There is considerable debate over how the long end of the market "should" react. It certainly can't wait 30 years to see what real after-tax yields will be. However, it probably wants more proof of Fed intentions. Furthermore, large budget deficits are widely forecasted, and repercussions are feared. The market is more likely to look to the future after it is assured that these deficits won't drive rates out of sight. It would need to see economic growth sustained without driving rates up to gain some measure of reassurance. Thus an edgy, overreactive bond market will be a problem for the Fed over the foreseeable future.

To the extent that the Fed may wish to twist the yield curve (raise short rates and hold long rates), its credibility is essential. Therefore, the Fed's monetary targets are essential too. Credibility is an ongoing characteristic that must be nurtured. Even with what the Fed has done in the past to reduce inflation, it's hard to get people to hold the long bonds as short rates rise. The Fed did try to sneak up short rates without a bond market reaction, but this strategy has proved unsuccessful. The Fed now confronts a strong economy, fast growing money, and prospects that further interest rate rises will spread across the yield curve. At this time, the policy trade-offs are bleak. Fear of budget deficits is so widespread that twisting the yield curve seems to be out of the question. When short rates rise, the long rates will go with them--at least for awhile.

Robert A. Brusca

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Market Yields

	7/8/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	10.50%	10.50%	16.50%
Effective since	2/28/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	12.00
Federal Funds	9.00	9.38	13.88
Repurchase Agreements	8.88	9.38	12.50
U.S. Treasury Issues			
Bills			
3 months	9.39	9.07	12.13
6 months	9.84	9.43	13.04
1 year	10.19	9.63	13.47
Coupons			
2 years	10.61	10.23	13.98
4 years	10.97	10.63	14.22
7 years	11.25	10.92	14.16
10 years	11.24	10.94	14.00
Long Bond	11.29	11.00	13.58
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.30	9.10	13.65
3 months	9.50	9.20	14.15
6 months	9.90	9.45	14.10
1 year	10.20	9.85	14.20
Banker's Acceptances			
1 month	9.30	9.05	13.75
3 months	9.55	9.15	14.00
6 months	9.85	9.45	14.05
Eurodollar Deposits			
1 month	9.75	9.50	14.63
2 months	9.88	9.63	14.88
3 months	10.00	9.63	15.13
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.27	9.02	13.21
1 month	9.33	9.19	13.84
3 months	9.47	9.34	14.17
Bank Holding Companies			
1 month	9.07	9.07	13.84
Dealer Placed:			
3 months	9.57	9.43	14.17
New AA Corporate Utility Bond	12.30	12.15	16.20
Tax Exempt			
6 month Project Notes	4.60	4.75	7.45
1 year AAA Bond	5.50	5.50	8.00
5 year AAA Bond	6.45	7.00	9.60
20 year AAA Bond	9.30	9.40	11.70

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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